Testimony
of
Mr. Donald J. Carty
Chairman and CEO, American Airlines

United States Senate
Committee on Commerce, Science, and Transportation

January 9, 2003

Good morning Mr. Chairman and Members of the Committee. Thank you for the opportunity to appear before you today to discuss the airline industry.

I am here today with two goals. First, to emphasize the magnitude of the problem that we as an industry face. Second, to convince you that we are responding to the crisis with a degree of self-help that is unprecedented in our industry's history.

What this testimony represents is a condensed version of a presentation that I have been making to our employees in dozens of meetings around our system. These meetings have immensely encouraged me because our employees have shown an unwavering sense of seriousness, knowledge, and commitment to fix the problems.

When we began the process of radical change at American, we decided that, as management, we could not possibly ask our employees to make sacrifices without, first, having done everything possible in our control to solve the problems and, second, taking the lead in making the same sacrifices ourselves. Both of these are important elements in making the permanent changes we need simply to survive.

I usually begin my presentations to employees by showing some commercials from various ad campaigns we have done over the years. I do so because, while the music and pictures may change a great deal, there is one constant at American that has always been our core strength: the high quality of our employees. At American, we understand this business is all about our employees, what kind of job they do, and their professionalism. That is going to continue to be at the heart of our culture and at the heart of the marketing to our customers.

With that said, it can't be stated strongly enough that the magnitude of the problem we face as an industry is absolutely staggering. So I will begin with some facts about the industry as a whole and then get much more specific about what we at American are doing about our own problems.

[Slide 1]

Let me start with some industry data. What you see on this first slide is a history of the profitability of the industry. You will recall, we had an economic downturn in the early 1990s, compounded by the Gulf War. We, like the rest of the economy, moved into a healthier period in the late 1990s, the longest period of sustained economic growth in recent U.S. history, with tremendous growth in the demand for travel.

Then in April of 2001, we began to see the impact of the economic downturn that was occurring. It started in the high tech and telecommunications industries, but quickly spread across the U.S. economy. American Airlines, in particular, was hit very early because of the level of capacity we operated in a number of markets where the high tech industry was concentrated, such as Dallas, Austin, Boston, and San Jose.

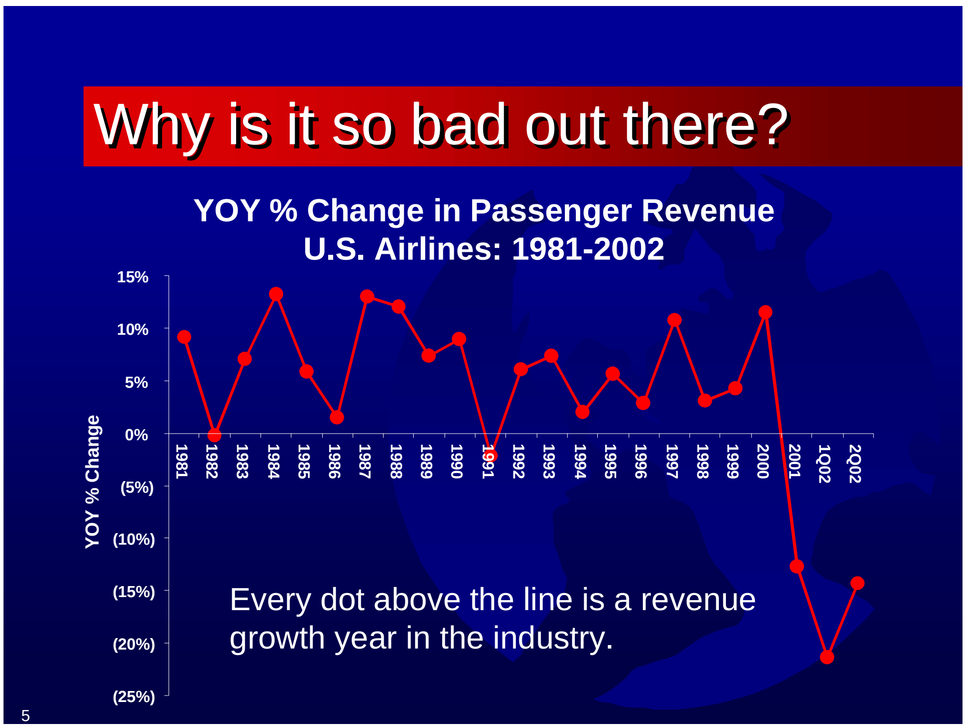
By the summer of 2001, we were already experiencing the financial consequences of the economic softening and recognized that the third quarter, typically a strong period, wasn't developing the way we had hoped. We knew then that we weren't going to have satisfactory financial results for the entire year.

At American, we began taking corrective action as soon as the downturn became apparent. A number of cost cutting measures were quickly initiated. Then came 9/11 and the devastating effect those terrible events had on our industry.

The very large losses recorded in 2001 and 2002 were the result of a weakened economy, the impact of 9/11, the fear of flying, followed by the public's aversion to the perceived hassle of flying due to the new security procedures. In addition, the new costs of increased security and insurance had a significant impact. In short, by the end of 2001, we had flown in economic terms into the "Perfect Storm."

To make this chart completely clear, the $7.7 billion lost in 2001 was after the government compensation of $5 billion. In other words, our actual losses were closer to $13 billion for the industry in 2001.

Many of us expected that the economy would begin to recover by the middle of 2002. We were also hopeful the effects of 9/11, which drove a great deal of traffic from our airplanes, would also dissipate, and that we would recover by year-end. Obviously that hasn't happened. In fact, Wall Street analysts now estimate that the industry lost $9 billion for the full year.



[Slide 2]

To give you some idea of the order of magnitude of the impact all of these events had on the market, Slide 2 shows the percentage change in total airline revenue for the whole industry year-over-year, for the past twenty years.

The graph shows that while revenue growth has fluctuated, historically it seldom went negative. However, for the period 2000-2002, revenue has literally "fallen off a cliff." Not only is the economy weak, but the airline industry's share of the economy is completely unhinged from anything we've ever seen before. At no time in the history of aviation has the industry suffered such great losses.

The next slide shows a major source of the recent problem.

[Slide 3]

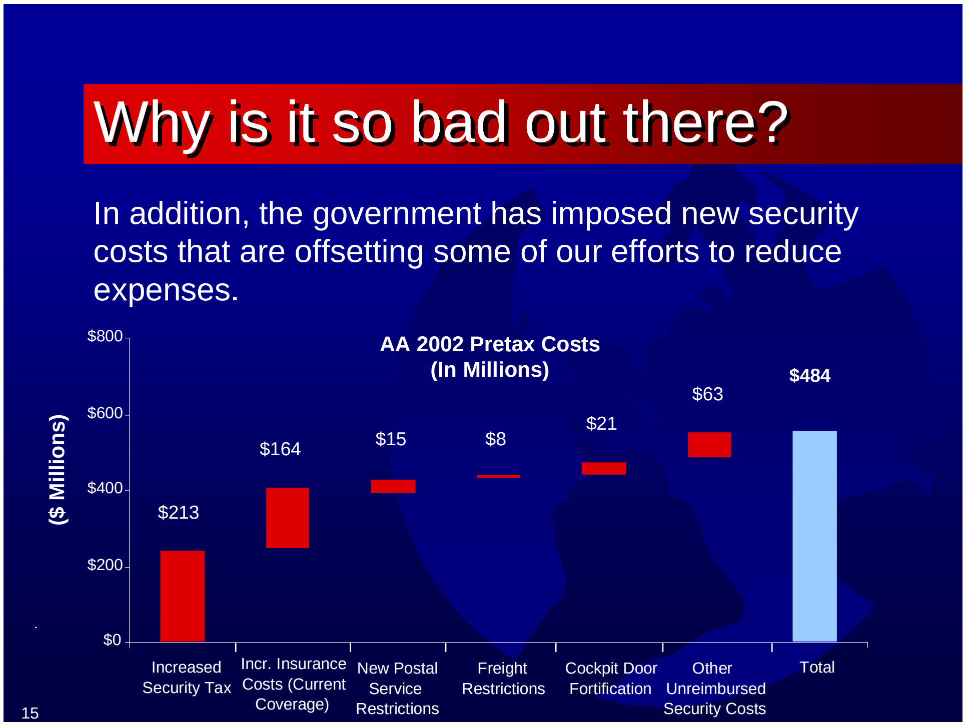
Since mid-2001, business travel has dropped precipitously. Corporate accounts tend to give us the best, high-frequency, high-yield business. These bars measure the deterioration of the amount of business trips that are taken. Comparing April 2000 to 2001, travel by the best corporate accounts for the entire industry (not just American) was down 25 percent during this five-month period. If you compare the year 2002, it's actually down over 40 percent.

In addition to the loss of business travel, the traditional network carriers must increasingly respond to the growth of discount carriers who generally set the price for leisure travel. In 1992, when we had our last economic downturn, these carriers represented 4.5 percent of the business. Today they're up to 18 percent and it looks like they'll be over 20 percent in 2003.

But that figure greatly understates their impact. While they are 20 percent of the capacity, discount airlines now operate in 70-80 percent of the markets served by the network carriers. The bulk of the markets not served by the discount carriers are the small communities, still served exclusively by network carriers and their affiliates. In short, low-cost carriers are influencing pricing in virtually every major market.

I raise this point not to complain, but to recognize a fundamental fact – the competitive landscape of our industry has changed forever. We cannot plan our business in anticipation of large increases in revenue and, therefore, must restructure to reduce costs.

Complicating this challenge is the problem that the post 9/11 world and resultant new security and insurance impacts have combined to drive our costs up dramatically. The impact on American Airlines alone was nearly half a billion dollars in 2002. Slide 4 indicates six elements contributing to that total.



[Slide 4]

The first column represents increased security tax. Although the security fee is technically a tax on our passengers, it actually became a cost to us. In the current marketing environment, we can only put passengers on the airplane by stimulating the market with price. To the extent we have to lower our prices to attract passengers, there is no way we can simply “tack on” a security tax without driving away passengers. In reality, the airlines are paying the tax because we have to get the total fare, including all fees and taxes, low enough that people are willing to fly. As a result, the security tax is costing American more than $200 million.

The second column represents increased insurance costs. This year, our insurance premiums increased $164 million. Of course, we are immensely grateful for your extension of the war risk program, without which this increase would be much greater. We hope that the current situation will be resolved in order for us to fully utilize this benefit.

The third column represents increased costs due to new postal service restrictions. We have not been allowed to carry mail over 16 ounces. At American alone, that cost is at least $15 million a year.

The fourth column represents additional freight restrictions that the government has imposed on us, costing us $8 million annually.

The fifth column addresses cockpit door reinforcement. Reimbursement for the mandatory cockpit door replacement has not equaled the costs incurred, with $21 million in additional costs.

The final column represents over $60 million in costs that we believe the government indicated they would pay for, such as catering security costs, that we have not received.

In total, that's nearly half a billion dollars in new costs for American. The industry's cost for security is over $3 billion. This, by the way, does not include the hundreds of millions in annual payments that carriers make to the federal government for security reimbursement costs.

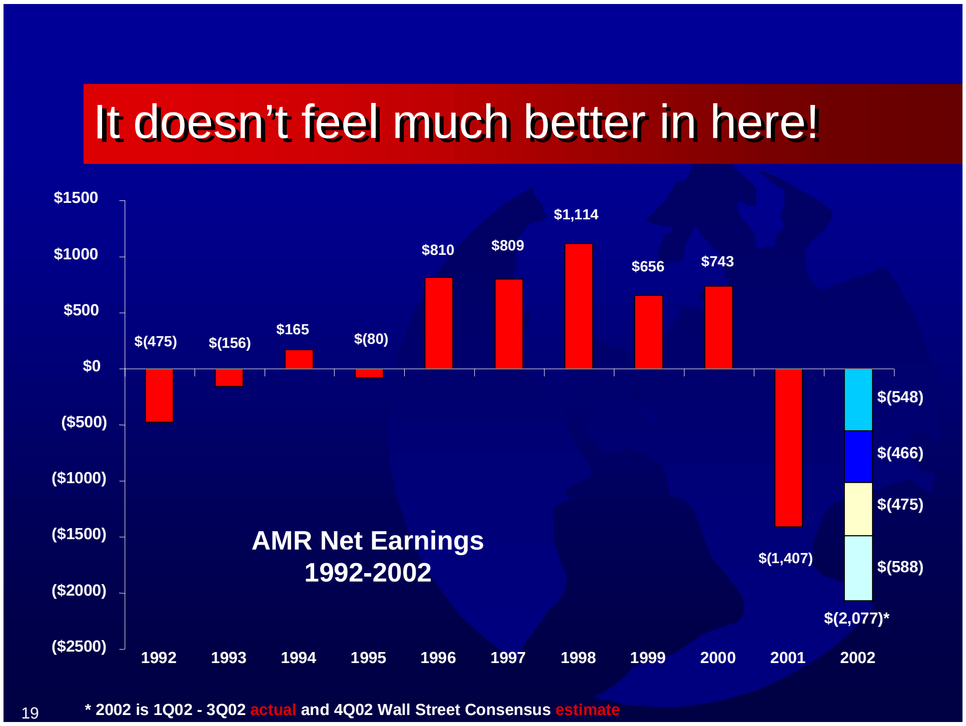
As we have said in the past, we believe that the public policy debate should be about national security, not airline security. We believe that protecting citizens against terrorism anywhere -- in airplanes, trains, buildings, shopping centers or stadiums -- is a government function. Unlike other industries, airlines are bearing a tremendous amount of the cost burden for security. Is there any reason to tax airline passengers for protection when we don't tax the people in Times Square on New Years Eve who were protected by the government, or citizens entering public buildings?

At the same time, I should acknowledge the very positive contributions of the TSA under the leadership of Admiral Loy. The agency is focused on providing excellent security, while, at the same time, helping us improve customer service. More needs to be done, but great progress has been made.

Moving from a discussion of the industry to the specific challenges we have at American, I explain to our employees that the only way we have survived these unprecedented losses is to borrow money. So the more money we borrow, the more interest we're going to have to pay, and the tougher it is to recover and return to profitability.

Secondly, I explain that low-cost carriers are everywhere – that's not going to change. While the network carriers have to retrench for economic reasons, the low-cost carriers are continuing to grow. It's a reality that's here to stay as we think about the next twenty to thirty years at American Airlines.

Furthermore, technology has made it easier to shop for the lowest prices. The majority of the traveling public has access to the Internet. In the airline business, you can find the lowest fare in 30 seconds. So our pricing is and will continue to be much more transparent than pricing for many other consumer products.

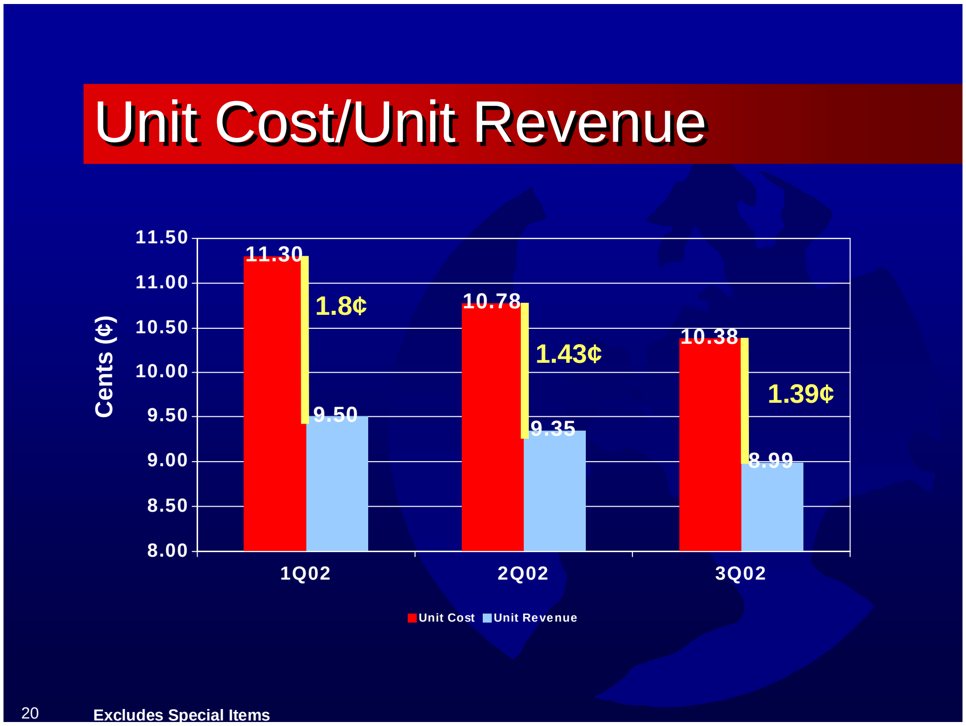


[Slide 5]

American has been uniquely challenged by the fact that the regions which have shown the greatest market softness were the domestic markets and Latin America, where American has the largest presence. We also saw relatively weak revenue and traffic at London Heathrow, where American has the largest of its European operations.

In addition, we continue to suffer from being the only international carrier not permitted to codeshare with our largest European partner. The DOT now has before it an application for a limited codeshare agreement between AA and British Airways. Expeditious approval of this codesharing, explicitly authorized under the U.S. – U. K. bilateral agreement, will permit American to begin marketing destinations beyond London that we cannot economically serve ourselves. This is a critical first step if we are to compete on equal footing with other major U. S. carriers.

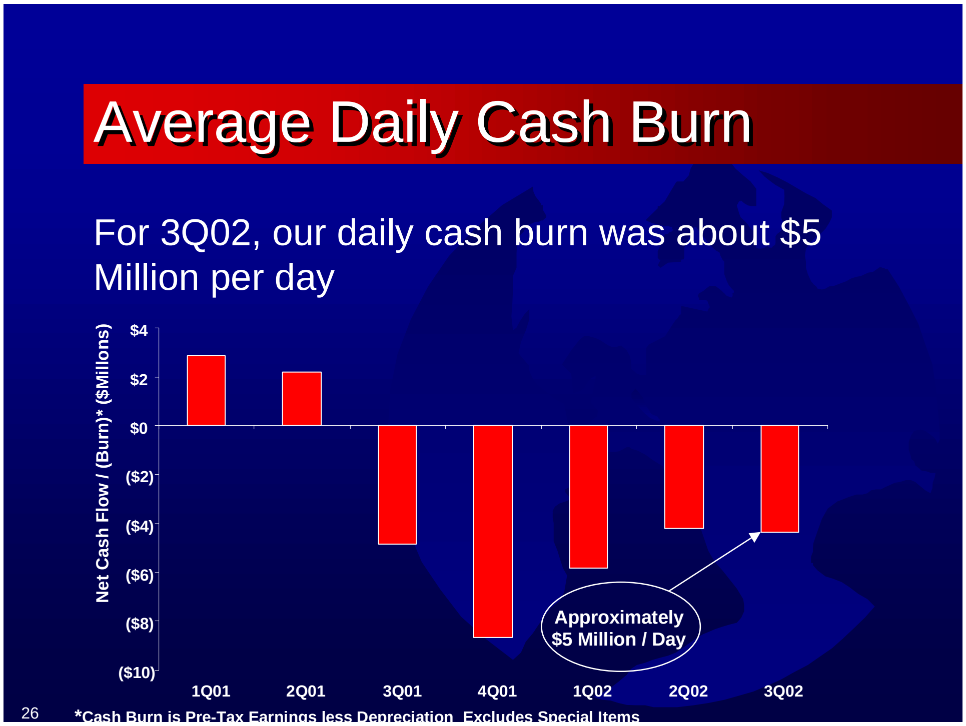
As we refocus our planning in 2003, we are shifting capacity to markets with stronger demand. We will adjust slightly our international routes and continue to curtail domestic capacity because of continued weakness in these markets.



(Slide 6)

This slide shows revenue per seat mile and cost per seat mile. We are getting our costs down and are making steady progress in narrowing the gap a bit, but we continue to have a tremendous difference between what it costs to run the airline and the amount of revenue our customers are willing to pay. The difference leads to increased borrowing.

Obviously we can't continue to do this for very long. The fact is we have been borrowing money just to pay the fuel bill and meet payroll.



[Slide 7]

For example, American had $2.5 billion in cash a year ago, and we still have $2.5 billion today. The problem is, in order to maintain that number, we've had to increase our capital borrowing. Since 9/11, American has borrowed approximately $6.5 billion, which has caused our debt to skyrocket. The chart in Slide 7 is sobering indeed. It indicates that in the 3rd quarter we were running through about $5 million a day in cash. At that rate, we don't have forever to fix our problems.

[Slide 8]

Devalued stock prices at all network carriers – not just American – have resulted in an all time low market capitalization for the industry.

If you think about this in historical context, in October of 2000, our stock was at almost $34 a share, a market capitalization of about $5 billion. At the close of business two years later (October 31, 2002) the stock was at $4.66, making it worth about three-quarters of a billion dollars.

Historically, American has relied on a relatively small number of our business customers being loyal to American. We began to recognize in the 90's that model was going to get tougher and tougher to sustain. With the downturn in business customer travel, we've had to find new ways to generate revenue.

There are many things we do as a large carrier that customers value and will always value. Customers do value convenience, network, and service. Nonetheless, we believe that to compete effectively, we have to get annual costs down by roughly $4 billion, permanently.

We are trying to reinvent ourselves as quickly as we can in a time of immense financial crisis. This is a plan we would have gradually implemented over five or six years. Now there's pressure to get there faster, and there's pressure to survive so we can get there at all.

At American, every aspect of our business is being reexamined. Literally hundreds of projects have been initiated to reduce expenses and restructure our business model.

These efforts have been grouped into seven major areas of the business. The first area of initiatives is scheduling efficiency.

As you know, American and many of our major competitors, both in the U. S. as well as foreign flag carriers, operate a hub and spoke scheduling system. This system has proven to be a very efficient means of providing frequent service between communities that otherwise would not have enough local traffic demand to support that service level. Business travelers have told us time and again that schedule frequency is a critical feature.

Just the same, the traditional approach to hub and spoke scheduling, in an effort to drive passenger connect times to an absolute minimum, has resulted in less efficient asset utilization. Historically, we have needed extra airport gates and manpower to support a schedule where the incoming bank of flights and outgoing bank of flights all arrived and departed within a narrow time window. In the current environment where there is less business demand traveling on higher fares, this scheduling approach is less effective.

In April 2002, we moved our Chicago hub operation to a depeaked schedule. We expanded this initiative to our Dallas-Fort Worth hub in November 2002. The gist of this concept is that planes arrive at uniform rates throughout the day. Ground times at the gate are based on how quickly our crews can turn the aircraft, rather than waiting to meet directional banks of aircraft.

The cost savings at O'Hare and DFW from this change have been significant. At O'Hare, we were able to operate the same number of frequencies with five fewer aircraft, four less gates, and we realized a 5% increase in employee productivity. These changes have also reduced congestion and delays at these airports, contributing to improvements in on-time performance, not only for AA but also for the industry. By de-peaking both O'Hare and DFW, we have been able to make improvements in our spoke airport gate and manpower productivity as well.

The impact to local Chicago and Dallas-Fort Worth passengers is all positive, with better spacing of flights throughout the day. This, in turn, helps to reduce waiting time at check-in and security. For connecting passengers, the average connect time has gone up roughly 10 minutes. When viewed in context of the overall trip length for connecting passengers, this is a fairly modest change. This fact has been reflected in our share of connecting passengers, which has actually been up slightly since the change.

The second major initiative we undertook was fleet simplification. As a carrier with service ranging from small cities in the U. S. to our hubs, large transcontinental U. S. markets, as well as an extensive international schedule, American will always need to operate with a few different fleet types. During the boom years, carriers like American could afford the extra costs of maintaining a large number of fleet types. This was possible because business travelers were willing to pay more for their travel and major carriers responded by offering specialized products. But in today's marketplace, the costs of having a diverse fleet outweigh the revenue we are able to generate. As such, we had begun work to simplify our fleet well before September 11.

In June 2001, American operated 12 different fleet types, requiring unique crew training, and 30 different subfleet types. Through aircraft retirement and standardization during the next few years, we will reduce the number of fleets requiring unique crew training to five and decrease the number of subfleets to ten and possibly fewer. When compared on the number of aircraft units per unique fleet type, American should be second only to Southwest by 2006.

The third area is to streamline our interaction with every single customer by simplifying processes and using automation to achieve better customer service and increased productivity. We are working aggressively to eliminate the need for paper tickets and to expand the availability and functionality of self-service devices to make our airports more efficient. Similarly, voice recognition and new automation tools will improve the efficiency of our reservation offices. At the same time, we will be shifting our reservation activity to our even lower cost platform by encouraging the increased use of the Internet. An example of this is providing customers the ability to book AADVANTAGE award travel on AA.com. This is all about having a customer service experience that's easier for the customer and less labor intensive for American.

The fourth area we are addressing is distribution and pricing. Distribution costs represent our third largest expense after labor and fuel. These costs include commissions, booking fees, credit card fees and a variety of other costs of making the sale. As part of the long-term restructuring of our business, we have targeted a number of strategic initiatives that will significantly reduce these costs – including a substantial reduction in commissions - without depressing revenues or adversely affecting customer service.

Over the past several years, Computer Reservation System booking fee expenses have increased far faster than inflation - about 7 percent annually since 1995 - even as technology costs have fallen. In 2002, we spent more than $400 million on booking fees, or about 2.4 percent of passenger revenue.

Booking fees have risen dramatically, largely because of outdated DOT regulations which do not allow us to bargain with individual Computer Reservation Systems, as we can with anyone else whose services we buy. Fortunately, the DOT has recently proposed new rules that would change this one-sided business relationship. We applaud the Department for this step and hope they move promptly with these proposed rules so that we can get this cost item under control.

As for our own efforts to reduce booking fees, we have recently launched the EveryFare program. The EveryFare program makes lower web-only fares available through participating travel agents who are willing to help us achieve lower distribution costs, equal to the costs on the Internet, for all bookings. This program is truly a win/win for consumers, travel agents, and American. Customers needing the assistance of a travel agent can still get access to our low-internet fares, and American will gradually reduce its total booking fee expense.

Our fifth area of cost reduction is our inflight product offering. The logistics behind providing meals on short domestic flights with limited ground time are extraordinary. While many customers have valued the level of meal service we have provided, few have valued it as much as it costs to deliver. This is particularly true given the increased security requirements for catering services after September 11. Increasingly, more and more of our customers simply want to make their own choices, prior to boarding the aircraft. To align with this evolving customer value equation, we have reduced the level and complexity of food service on most of our shorter haul flights.

This simplification of our inflight product is not limited to food service. We recently announced that there would no longer be any charge for in-flight movies, provided that customers bring their own headsets. For customers not bringing their own headsets, we sell headsets onboard. The net impact is more customer self-sufficiency and less logistical challenges for American, resulting in lower overall costs.

Our sixth area of emphasis is flight operations. In an effort to make our flight operations more efficient, we're focusing on the fundamentals of the business: operational safety, performance and efficiency. AA's arrival performance this year has improved in every quarter as compared to 2001. Over 84 percent of our flights arrived on time in the third quarter of 2002. Everyone in the operation has contributed to this improvement.

In addition to flight and maintenance savings generated by fleet simplification and de-peaking, AA is also making changes to lower other operational costs. Fuel is our second largest operational expense after labor. We have taken a number of steps which, while seemingly small, result in significant cost savings. The largest improvement is that we have reduced aircraft auxiliary power unit fuel usage by half during the time the aircraft is parked at the gate. This has been achieved by acquiring ground equipment to provide power and air-conditioning to the aircraft and through comprehensive training and awareness programs for airport and flight crews. Fuel reductions have also been achieved by running aircraft taxi operations to and from runways on a single engine and by more closely monitoring excess ramp arrival fuel levels.

We are also implementing changes in our maintenance areas, which will enable us to operate more efficiently. Portable technology, which gives mechanics and inventory clerks up-to-date information on parts availability, will significantly improve productivity. Automation of the work card system will also allow our mechanics to maintain aircraft more efficiently.

Returning to profitability and running a safe airline are not mutually exclusive. As we continue to focus on operating a streamlined and efficient company, our employees know that the most important contribution they make is doing their jobs safely.

The seventh and final area of cost reduction initiatives includes looking at ways to streamline our headquarters and administrative functions. As American's losses continue to mount, we're leaving no stone unturned, reducing everything from staffing to paper paychecks to the way we buy our supplies. So far, we've implemented and/or identified cost-savings in management productivity, supplier strategy, facilities consolidation, capital spending, human resources and accounting. Combined, these savings total more than $500 million in reduced annual expenses. Here's a closer look at what we've done in each of these areas.

We are lowering the cost of purchasing goods and services by rigorously examining everything we purchase and determining ways to save every possible dollar. We are combining volumes of business with suppliers to get higher discounts, reducing inventory levels, rolling out global sourcing strategies, utilizing eBusiness tools and identifying opportunities to lower our suppliers' costs that are passed on to us.

In conjunction with looking at how we work, we're looking at where we work. Every square foot of space we can give back to the landlord saves us money.

Airport construction projects have been either deferred or scaled back significantly, saving more than $250 million in capital commitments. Those few projects that are going forward are, in most cases, projects that would cost more to cancel or are being funded directly by the airport. We've also cut capital spending in other areas. Since the fourth quarter of 2001, we have deferred the delivery of 40 aircraft, saving over $3 billion. And we've cut spending on aircraft modification projects, information technology and ground equipment. In total, we have deferred more than $4 billion in capital spending from our pre-9/11 plan.

In the Human Resources area, we are aggressively using automation to move paper processes and human-assisted transactions to online self-service. Ultimately, Jetnet, our employee Internet portal, will be a convenient, one-stop resource: "From hire to retire, everything online." Already, our employees can go to Jetnet for benefits enrollment, pension/401k transactions, employee support and payroll services, company communications personalized to each workgroup, real time operations information, policy and technical manuals, and company reference information. In addition, all employee travel is planned and booked online, executed via self-service check-in, and will be completely paperless in 2003.

We are looking at ways to battle skyrocketing health benefit costs, a problem not just for American, but for corporate America as well. We are increasing our focus on preventative healthcare, encouraging the use of generic versus brand drugs, and requiring higher co-payment amounts, resulting in more than $14 million of cost avoidance.

We've made similar automation strides in accounting, with a relentless focus on going paperless. In payroll, disbursements, and revenue accounting, we are moving rapidly to 100% electronic. These efforts will produce great savings for us, and greater service for our customers.

Since September 11, American has reduced its management and administrative headcount by 22 percent. In addition, management employees have received no pay increases since 2000, and will not see one in 2003. Company wide, across all labor groups, job reductions to date total about 27,000, and -- unfortunately -- we're not out of the woods yet. As we adapt to the new and increasingly low cost business model, our company will look very different from what we've known in the past. Our ability to adapt will be critical to our survival.

Many of these cost cutting ideas were submitted by our employees. Our people stepped up to the plate in a big way when I asked for cost-savings ideas. They submitted ideas that ranged from revising our headset policy to limiting the distribution of ticket jackets. To date, thousands of ideas have been received. Of these, hundreds have been implemented and dozens more are under review. When tallied, we estimate that employee ideas have saved the company hundreds of millions of dollars.

So far I've talked about restructuring in seven major areas where we've been actively seeking to reduce costs. In total, these changes will produce $2 billion of annual cost savings when fully implemented. With that being said, I haven't addressed an area equally important to our recovery – that is restructuring our labor costs. Labor is our company's single greatest expense and, with the exception of taxes, our fastest growing expense. In fact, at about 40 percent of our total operating costs, it's more than three times our next biggest expense.

Despite its importance, there's a reason I mention labor costs last. Unlike some of our competitors, we recognized early on that the industry's problems were structural and not simply the result of a typical business cycle. And so, rather than merely cut pay and benefits, we took a different tack in attempting to solve our financial problems. Instead, we first set out to do everything that was under management's control to change how we operate, increase efficiency, eliminate waste, cut expenses and so on – all encompassed in the seven areas that I've just discussed with you.

Throughout that process, we have valued labor's input. And indeed they have certainly borne their share of our common challenge thus far, with the staffing cuts that I've mentioned previously and by working harder and doing more with less. But because our financial task is so great, we must also examine our labor costs – just as we have in every other area - if we are to stem our losses, remain competitive, and return to profitability. That's not an easy thing to do, indeed it can be extraordinarily difficult for everyone, but it must be done.

Toward that end, we've met with our unionized groups, as well as our non-represented employees, all across the company to ask for their help. We've explained our situation clearly and even given them complete access to our financial data so they could make informed decisions. To date, we've asked that everyone forego scheduled wage increases next year – management included. We must go further, however, and we're requesting productivity improvements and increased flexibility from all work groups to lower our labor costs.

Through it all, we've worked hard to build credibility between management and labor. Our goal has been to create a partnership that will allow us to successfully meet the fundamental challenges we face. It's time now for that partnership to produce results, beginning with an acknowledgement of the depth of our problems, a recognition of the changing nature of our true competition and a restructuring of our labor agreements to allow us to effectively compete. We're hopeful we'll be successful in that regard. As I continue to tell employees at our town hall meetings, we have an opportunity to demonstrate to ourselves and to the world that an airline can save itself by working together, cooperatively and creatively.

In a peculiar way, however by emphasizing the positive steps that we are taking and our determined spirit of optimism, I worry that I have understated the magnitude of the crisis and the importance of your role in working with us to solve the problems of our industry.

There are, in fact, two more clouds on the horizon that are very troubling. First is the rapid increase in fuel prices. One of the few things that saved us last year was a substantial drop in year-over-year fuel costs. Those savings are now long gone. Fuel is spiking rapidly and this will add significantly to our cost challenges in the months ahead. This is, perhaps, as much driven by the situation in Venezuela as by the Middle East crisis. But it is a very real problem indeed. Moreover, the predicted colder winter in the Northeast will add further to the problem since jet fuel and home heating fuel are, for the most part, the same commodity and increased demand for either drives up the price for both.

The second cloud is the impending conflict in Iraq. If the history of the Gulf War is any indication, a conflict in Iraq will have very profound and adverse consequences for the airline industry. We are planning for this probability to the best of our ability. But a combination of even higher fuel prices, together with a precipitous drop in demand, will be an extraordinary challenge for us all.

A year ago, this Committee and the leadership of Congress rallied in a time of crisis to provide us a lifeline. I simply can't state strongly enough how important that was. You literally saved our industry. We continue to be grateful beyond words.

As I have indicated in this and previous discussions, we continue to need your help in the areas of security costs and taxes; however, that is not my primary mission today. Rather, my goal is to let you know that we are exhausting every conceivable means of self-help. At American that process is not yet complete. Our dialogue with our employees is intended to build a consensus within our company about a survival strategy. I can assure you there will be sacrifices needed by every single person involved, including, most certainly, both myself and the officers of the company. Indeed, the largest cuts to date have been in management -- 22 percent are gone permanently. By most corporate standards, we are running a very lean machine. After 9/11 all the officers took pay cuts, bonuses were eliminated, and managers' salaries were frozen.

In summary, that is our situation as of January 9, 2003. We hope it will improve and are doing everything in our power to make that happen. And finally Mr. Chairman and Members of the Committee, we are most grateful for both the reality and the symbolism of the Committee choosing the concerns of the airline industry for one of its first hearings of this Congress. We look forward to continuing this dialogue and working with you throughout the year.